

**STATE OF ILLINOIS**

**ILLINOIS COMMERCE COMMISSION**

Illinois-American Water Company	:	
	:	
Proposed general increase in	:	02-0690
water rates.	:	

**PROPOSED ORDER ON REHEARING**

By the Commission:

**I. PROCEDURAL HISTORY**

In this proceeding, Illinois-American Water Company ("Illinois-American," "IAWC" or the "Company") filed its new and/or revised tariff sheets for water and sewer service ("Proposed Tariffs"), in which it proposed a general increase in water and sewer rates. The Proposed Tariffs were suspended by the Illinois Commerce Commission ("Commission"), and the matter was set for hearing.

Petitions for Leave to Intervene were filed by the Citizens Utility Board ("CUB"); People of the State of Illinois ("Attorney General" or "AG"); Air Products and Chemicals Inc., Caterpillar, Inc., Cerro Copper Products, and Granite City Steel, as the Illinois Industrial Water Consumers or "IIWC"; City of Pekin; City of Waterloo, City of O'Fallon ("O'Fallon"), Village of Bolingbrook ("Bolingbrook"); Fosterburg Water District ("Fosterburg"), Jersey County Rural Water Company, Inc. ("Jersey County Rural Water") and Bond-Madison Water Company; Mitchell Public Water District; United States Executive Agencies ("USEA"); International Union of Operating Engineers, Locals No. 2, AFL-CIO; and the City of Peoria. The City of Streator and the City of Lincoln filed appearances (jointly, "Lincoln/Streator"). The IIWC, City of Waterloo, Bond-Madison Water Company, Fosterburg Water District, Mitchell Public Water District, Jersey County Rural Water and Scott Air Force Base jointly filed testimony and briefs as the "Illinois Large Water Consumers" or "LWC".

Appearances at the hearings were entered by counsel on behalf of IAWC, the LWC, O'Fallon, Bolingbrook, Lincoln/Streator, the AG, CUB, Waterloo, USEA, and Commission Staff ("Staff"). After that, various parties filed initial briefs and reply briefs.

The Commission entered its Order in the proceeding on August 12, 2003. IAWC filed new tariff sheets as authorized in the Order. Those tariffs went into effect shortly thereafter, and the rates contained in those tariffs are referred to in the instant Order as the "current rates" or currently effective rates.

On or before September 11, 2003, **Applications for Rehearing** were filed by the Village of Bolingbrook, the Large Water Consumers and Illinois-American on various issues.

On September 30, 2003, the Commission granted, in part, the Application for Rehearing filed by the Village of Bolingbrook in order to allow additional evidence on the calculation of the portion of the "Citizens acquisition savings/sharing" adjustment that is attributed to savings in labor and labor-related expenses resulting from the acquisition by IAWC of the assets of Citizens Utilities Company of Illinois ("CUCI" or "Citizens"). The Commission also granted, in part, the Application for Rehearing filed by the Large Water Consumers in order to allow evidence regarding the allocation of the revenue shortfall resulting from the competitive rate for the City of O'Fallon. In addition, the Commission granted, in part, the Application for Rehearing filed by IAWC to allow evidence regarding the date by which the Company must file a petition for approval of certain agreements with affiliates. The Commission denied the Applications for Rehearing filed by Bolingbrook, LWC and IAWC in all other respects.

Pursuant to due notice, a prehearing conference was held before a duly authorized administrative law judge of the Commission at its offices in Springfield, Illinois. Thereafter, an evidentiary hearing was held on December 4, 2003. Appearances were entered by counsel on behalf of IAWC, LWC, Bolingbrook, the AG, O'Fallon, the City of Streator and Staff. The Company presented the testimony of Frederick L. Ruckman, its Vice President, Treasurer and Comptroller, and Ronald D. Stafford, its Director of Rates and Revenues, Assistant Treasurer and Assistant Comptroller. LWC presented the testimony of Michael P. Gorman of Brubaker & Associates, Inc. Staff presented the testimony of Mary H. Everson, an Accountant in the Accounting Department of the Financial Analysis Division and Mike Luth, a Rate Analyst in the Rates Department of the Financial Analysis Division. At the conclusion of the hearing, the record was marked "Heard and Taken."

Initial and reply briefs on rehearing were filed by LWC, IAWC, and Staff and jointly by the AG and CUB ("CUB/AG"). Unless otherwise noted, citations to briefs are to those filed on rehearing.

## **II. SAVINGS/SHARING ADJUSTMENT ASSOCIATED WITH CUCI ACQUISITION**

The Village of Bolingbrook filed for rehearing on two issues, one of which concerns the 50-50 sharing, by ratepayers and shareholders, of alleged savings in labor and labor-related costs resulting from Illinois-American's acquisition of the assets of Citizens Utilities Company of Illinois. This issue is addressed in Section V.G. of the Order entered August 12, 2003.

By way of background, it is noted that the transactions by which IAWC acquired the properties of CUCI were the subject of Docket No. 00-0476. On page 39 of its Order in Docket 00-0476, the Commission directed IAWC to file a petition seeking approval of a specific methodology for quantifying acquisition savings. The Commission

further found that “to the extent a methodology for quantifying Acquisition savings is approved in the proceeding discussed immediately above, the revenue requirement will be allowed to be increased to account for 50% of the demonstrated Acquisition savings only in rate cases filed within three years of the date of this Order.”

Thereafter, in Docket 01-0556, IAWC filed a petition seeking approval of a specific methodology for quantifying acquisition savings. In that docket, the Commission entered an order approving a methodology for quantifying acquisition savings for use in the next rate proceeding.

In the initial phase of the instant case, the Company presented IAWC Exhibit 12.0, Schedule C-2.4, which contains IAWC’s calculation of Acquisition Savings/Sharing by district. The schedule identifies five categories of costs in which such savings purportedly occurred, one of which is “labor and labor-related”. Fifty percent of the alleged savings in each of the five categories was added to the Company’s proposed revenue requirement.

In its brief filed prior to entry of the Order of August 12, 2003, the Village of Bolingbrook proposed an adjustment to disallow IAWC’s calculation of labor and labor-related savings in its revenue requirement. In the Order entered August 12, 2003, Bolingbrook’s adjustment was not adopted.

In its rehearing application, Bolingbrook again questioned how Illinois-American could claim substantial “savings” in labor and labor-related costs while also proposing an amount of 2003 test year labor expense for the Chicago Metro District that is substantially higher than in recent years.

On September 30, 2003, the Commission granted rehearing on this issue in order to allow additional evidence on the calculation of the portion of the “Citizens acquisition savings/sharing” adjustment that is attributed to alleged savings in labor and labor-related expenses resulting from the acquisition by IAWC of the assets of CUIC.

On October 29, 2003, however, Bolingbrook filed a “Motion to Withdraw Request for Rehearing regarding ‘Labor-Related Savings’.” On October 31, 2003, Staff and the Company filed responses to Bolingbrook’s Motion to Withdraw, therein indicating no objection to the motion. No other party responded to Bolingbrook’s motion to withdraw, and no other party chose to pursue the opportunity to present testimony on rehearing on this issue.

In view thereof, the Commission finds that the conclusions in the August 12, 2003 Order on this issue should be affirmed on rehearing.

### **III. IAWC’S AGREEMENTS WITH AFFILIATES**

As discussed in Section V.F. of the Order of August 12, 2003, the magnitude of increases in test year management fees to be paid by IAWC to affiliates was a

contested issue in the proceeding, as was the question of whether the services in question may be available on a less costly basis from competitive suppliers. As part of its conclusions on this issue in the Order entered August 12, 2003, the Commission observed that the amount of management services and fees has increased significantly in recent years, and the Commission found that the Company's current operating agreements with affiliates should be the subject of a review prior to the next rate case.

Thus, in order to facilitate an efficient and meaningful review of test year management fees in the next rate case and to ensure that ratepayers are being adequately protected by the terms of the current agreements, including those relating to allocation and competitive pricing procedures, the Commission directed the Company to file a petition, within six months after the entry of the Order entered August 12, 2003, seeking approval of IAWC's operating agreements with affiliates. The six-month period was intended to give the Company time to review the agreements and incorporate any proposed revisions it deems appropriate.

In its rehearing application, the Company requested, among other things, that the date for the filing of the petition be extended to 12 months from the date of the Commission's action on the Company's rehearing application. On September 30, 2003, the Commission granted, in part, IAWC's request for rehearing on this issue in order to allow evidence regarding the date by which IAWC must file a petition for approval of the agreements in question. Thus, IAWC requests that it be given until September 30, 2004 to make the filing.

On rehearing, IAWC witness Ruckman testified in part that extending the date for the filing to September 30, 2004 would allow the Company sufficient time to conduct a conscientious review of the agreements and to prepare the petition for approval of them. (IAWC Rehearing Ex. 1 at 3-4)

Staff witness Everson testified that Staff has no objection to the Company's request for an extension of time to file for approval of its operating agreements with affiliates. (Staff Ex. 21.0 at 2)

Having reviewed the record on rehearing, the Commission concludes that the date by which IAWC is directed to file the petition in question should be extended to September 30, 2004, in order to give the Company additional time to thoroughly review the agreements and incorporate, in the filing, any proposed revisions it deems appropriate.

#### **IV. ALLOCATION OF REVENUE SHORTFALL ASSOCIATED WITH O'FALLON AGREEMENT**

##### **A. Background**

As explained in the Order of August 12, 2003, pages 87-88, 111-112 and 123-124, IAWC and the City of O'Fallon signed a "letter of Intent" that "states [their] . . .

intent . . . to negotiate and enter into a definitive written agreement . . . under which IAWC will sell and deliver to the City, and the City will purchase and receive, as the City's sole source of supply, all of the City's water supply requirements for its entire water system." (IAWC Ex. FLR-1) The letter of intent also identifies the initial competitive rate of \$1.69 per gallon to be charged. The Letter of Intent was first provided to other parties, and entered into the record, at the evidentiary hearings.

IAWC asserted that the revenue requirements assigned to O'Fallon, but not fully recovered under the competitive rate, should be recovered from other customers in the rate area of which O'Fallon is served, which is the Southern, Peoria and Streator or "SPSt" rate area.

As indicated in the August 12, 2003 Order, pages 87-88, Staff stated that if the competitive rate for O'Fallon were approved, it would be necessary for other customers to pay the revenues lost as a result of the lower rate paid by O'Fallon in order for the Company to recover its revenue requirement. This revenue shortfall is calculated to be approximately \$330,000, which is approximately one-eighth of the estimated revenues that would be collected from O'Fallon under otherwise applicable rates. Staff attached to its initial brief, filed May 21, 2003, a set of schedules that purportedly contain cost of service studies, rates and bill comparisons that reflect the effect of the O'Fallon-IAWC agreed-upon rate.

In the Order of August 12, 2003, pages 123-124, the Commission concluded that based on the information provided, the competitive rate specified in the Letter of Intent is reasonable. The Commission found that O'Fallon does in fact have a competitive alternative by which sufficient supplies of wholesale water could be obtained at a price more economic than that available under the Company's regular rates, and that there is a strong possibility O'Fallon would leave the system if a competitive rate were not available from the Company. Furthermore, the Commission noted, the rate to be paid by O'Fallon in the Letter of Intent is toward the high end of the estimated range of costs for obtaining water under the alternative supply option, and is higher than the competitive rates in other Competitive Service Tariffs.

The Commission further found that retaining O'Fallon as a customer on the IAWC system will still provide significant net benefits to other customers, even if the revenue shortfall is allocated to them, because the amount of revenues lost if O'Fallon left the system is approximately seven times the amount of the revenue shortfall being allocated.

Accordingly, for purposes of this proceeding, the Commission determined in its August 12, 2003 Order that the Company should file tariffs specifying the initial competitive rates identified in the Letter of Intent as well as the method for making subsequent modifications to the initial rates. Further, the Commission found that rates for other customers should be adjusted to cover the revenue shortfall resulting therefrom, using the methodology set forth by Staff.

In its Order of August 12, 2003, the Commission also found, except as otherwise noted, that the cost allocations, class revenue recovery ratios, and rates designed in Staff's Cost of Service Studies are reasonable for purposes of this docket, and that Staff's cost of service studies should be used as the basis for setting rates in this proceeding.

Thereafter, IAWC filed tariffs intended to reflect the findings of the Commission, including the findings relating to the discounted O'Fallon rates and the allocation of the resulting shortfall to other customers. Those tariffs are currently in effect. The rates contained in those tariffs are referred to in this Order as the "current rates" or currently effective rates.

## **B. Rehearing**

As noted above, Large Water Consumers requested rehearing on the issue of the allocation of the revenue shortfall resulting from the competitive rate for the City of O'Fallon. On September 30, 2003, the Commission granted, in part, the rehearing application of LWC, in order to allow evidence on this issue.

### **LWC's Position**

LWC takes issue with the manner in which the revenue shortfall from the competitive rate for the City of O'Fallon is allocated to other customers. On rehearing, LWC addressed this issue in its briefs and through the testimony of Mr. Gorman of Brubaker & Associates, Inc. (LWC Ex. MPG-3) According to LWC, because of the timing of the presentation of the letter of agreement between IAWC and O'Fallon, other parties were not able to suggest a mechanism for recovery of the revenue shortfall resulting from the competitive rate in the letter of agreement. (LWC brief at 1-2)

On rehearing, Mr. Gorman proposed rates for the Southern, Peoria and Streator Districts (S/P/St) that allocated the revenue shortfall on the basis of an approximately equal percentage adjustment to IAWC's standard usage rates. (LWC brief at 1; LWC Ex. MPG-3 at 1) The rates proposed by Mr. Gorman are shown in Schedule 1 to his testimony.

Mr. Gorman said his rates were developed starting with usage rates proposed by Staff in its rebuttal testimony of May 2, 2003. (LWC Ex. MPG-3 at 2; LWC brief at 2, citing Staff Ex. 18.0, Schedule 18.2 - S/P/St. Rev. at 1) LWC says these rates were then adjusted to reallocate the shortfall back to the remaining customers and to adjust for differences between (1) the May 2, 2003 Staff rebuttal revenue requirement, reflecting Staff's revised rebuttal rates, and (2) the Commission's approved revenue requirement. (LWC brief at 2)

According to LWC, Mr. Gorman then allocated the revenue shortfall back to the usage blocks, based on an equal percentage basis, to the standard usage rates only. Mr. Gorman testified that under his proposal, residential rates would increase by

\$0.0093 per hundred cubic feet ("Ccf") and that a large residential customer would see an increase in its monthly bills of 6.5 cents per month. (LWC brief at 2; LWC Ex. MPG-3 at 3)

LWC says Mr. Gorman's proposed rates reflect a methodology for allocation of the revenue shortfall that is consistent with Staff's methodology for allocation of the difference between Staff's proposed revenue requirement and the revenue requirement ultimately approved by the Commission. (LWC brief at 3)

### **IAWC's Position**

On rehearing, IAWC addressed this issue in its briefs and through the testimony of Mr. Stafford. (IAWC Rehearing Exs. R-1 and SR-1) IAWC recommends that the changes proposed by LWC be rejected and that no changes be made to the rates that are currently in effect.

According to IAWC, if LWC's proposed rates were adopted, the vast majority of affected customers actually would experience a small rate increase and any rate reductions to other customers would be miniscule. (IAWC brief at 5, citing IAWC Rehearing Ex. R-1 at 4) IAWC asserts that any reduction in the second, third and fourth blocks would be less than three-quarters of one percent, and, for example, a reduction to the second block of the Southern Division would be 58 cents for every \$100 of billing in that block. IAWC contends that LWC's proposal would not accomplish any material benefit for anyone. (IAWC brief at 5; IAWC reply brief at 2 and 4)

IAWC also complains that if LWC's proposed rates were adopted, potential customer confusion likely would result. IAWC believes it is likely that residential customers will assume the Company is receiving another rate increase in addition to the rate increase authorized in August. IAWC claims they will not understand the purpose of LWC's proposed rate changes, which may cause them to make complaints and inquiries to both the Commission and the Company. (IAWC brief at 7, citing IAWC Rehearing Ex. R-1 at 5; IAWC reply brief at 2) IAWC further argues that a change in rates after only six months creates rate instability.

IAWC further complains that in order to implement LWC's proposal, IAWC would incur additional costs to prepare and file new tariffs, notify customers, notify the call center, modify volumetric rates, test new rates, provide for implementation of new rates by IT, and verify that customer billings are properly calculated for a full 30 day billing cycle after new rates are loaded. IAWC asserts that the estimated time involved with these additional activities is approximately 300 hours. IAWC believes that the additional cost outweighs any benefit larger water users might receive. (IAWC brief at 7, citing IAWC Rehearing Ex. R-1 at 5)

In opposing LWC's proposal, IAWC also says it agrees with Staff's comments that LWC's proposal would create further departures from cost of service. (IAWC brief at 8-9; IAWC reply brief at 3; IAWC Rehearing Ex. SR-1) The Company presented a

“percentage of cost of service” chart showing revenues as a percentage of cost of service, by class, at currently filed rates and at the rates recommended by LWC. (IAWC Ex. Rehearing SR-1 at 2-3)

IAWC also argues that LWC witness Gorman offered no reason or explanation for changing the existing rates. According to IAWC, neither Mr. Gorman nor LWC’s brief asserted that the present rates were erroneous. In IAWC’s view, LWC has failed to show the necessity or purpose for its proposal to change the present rates. (IAWC reply brief at 4)

In the event that LWC’s proposal is adopted over IAWC’s objections, IAWC contends that three “corrections” are required. With regard to the first two corrections, IAWC says Mr. Gorman’s Schedule 1 contains two errors regarding rates currently in effect. First, IAWC argues, the third block for Streator actually is the same as the third block for Southern. Second, there is a fourth block for Streator, which is the same as the fourth block for Southern. (IAWC Rehearing Ex. R-1 at 4, IAWC brief at 4-5) IAWC states that Mr. Gorman’s schedule should be modified accordingly.

As for its third “correction”, IAWC argues that there should be no reduction to Mr. Gorman’s proposed rates for the third and fourth blocks for Peoria. In IAWC’s view, since the Commission’s ultimate goal is to move fully Peoria to Southern/Streator single-tariff pricing, it is counterproductive to decrease the rates for Peoria. IAWC asserts that elimination of Mr. Gorman’s proposed reduction to the Peoria third and fourth block rates results in a slight reduction to the Southern/Streator fourth block rates. IAWC contends that no further adjustment should be made to the third block because the third block rates, as proposed by Mr. Gorman, already reflect a larger percentage reduction than his proposed second block rates and adjusted fourth block rates. (IAWC brief at 5, citing IAWC Rehearing Ex. R-1 at 6)

IAWC witness Stafford presented a schedule that shows Mr. Gorman’s proposed rates with the modifications discussed above.

### **Staff’s Position**

On rehearing, Staff addressed the revenue shortfall allocation issue in its brief and in the testimony of Mr. Luth. (Staff Ex. 22.0-2d Revised) In Staff’s opinion, the rates currently in effect are reasonable, and the rates proposed by LWC are also reasonable, “depending upon the Commission’s priorities”. (Staff brief at 4-5)

According to Staff, if current usage rates are to be revised, Mr. Gorman’s proposal is the best alternative. Staff says that Mr. Gorman’s proposal is a formulaic approach to adjusting the usage rates proposed in Mr. Luth’s rebuttal testimony, so that differences in revenue requirement and standard tariff usage billing units affect Staff’s proposed rates on a percentage basis, more or less equally. (Staff brief at 5)



Staff states that the residential increase and non-residential decreases under Mr. Gorman's proposal are less than one-half of one percent. Staff asserts that Mr. Gorman's proposal is reasonable because his method of adjusting Mr. Luth's proposed rates parallels Staff's recommended approach to adjusting rates for revenue requirement differences of less than five percent. (Id.)

Staff claims that with revenue differences of less than one percent, Mr. Gorman's proposal will not result in severe consequences or excessive benefits for IAWC customer groups compared to rates currently in effect. Staff states that residential customers billed entirely in the first usage block would experience no more than approximately one-third of one percent of an increase. Staff says that since the first usage block covers the first 30 usage billing units, a residential customer billed approximately \$89 to \$91 under current rates would be billed a "hardly noticeable" additional 28 cents under Mr. Gorman's proposal. Staff asserts further that since the second usage block is lower than current rates under Mr. Gorman's proposal, the increase to a high-use residential customer billed in part through the second usage block would be less than 28 cents. (Staff brief at 5)

As noted above, Staff contends that the rates currently in effect are also reasonable and are based on the Order. (Staff Ex. 22.0-2d Revised at 5) According to Staff, while Mr. Gorman's proposal does not result in significant increases to residential customers, his proposal nevertheless is an increase to the residential class, which is already paying approximately 105.6 percent of test year cost of service under rates currently in effect. Staff states that "the rates currently in effect place more of an emphasis upon minimizing the allocation of the O'Fallon discount to residential customers already paying a fairly significant percentage above cost of service." (Staff brief at 6) On this point, Mr. Luth testified, "With residential customers paying more than cost of service, current rates place more of a priority on maintaining residential revenues at the same percentage of cost of service when reallocating the O'Fallon discount among customer classes." (Staff Ex. 22.0-2d Revised at 5)

Staff suggests that the Commission must decide whether the additional increase to residential customers, though minor, is worth the small decrease for commercial and industrial customers, and other public utilities. Staff also says a change to rates will result in increased costs to the Company and may result in customer confusion or discontent for those customers who review all factors on their monthly billings. Staff adds that commercial and industrial customers absorbed the largest percentage increases in monthly billings as a result of rates currently in effect.

As discussed above, IAWC contends that three "corrections" are required in LWC's rate proposal in the event LWC's proposal is over IAWC's objections. Staff agrees with the first two of the Company's three recommended corrections to the LWC proposal. (Staff reply brief at 2)

According to Staff, IAWC's third "correction" of the LWC proposal is more of an alternative proposal than it is a correction. Staff believes LWC's proposal is preferable

to IAWC's "correction" because LWC's approach is formulaic and thus requires less judgment. (Staff reply brief at 2-3) The Commission observes that Staff did not address this issue until its reply brief.

### **Position of CUB/AG**

While they did not offer testimony on rehearing, CUB/AG did file briefs on the issue of how the revenue shortfall resulting from the O'Fallon agreement should be allocated. CUB/AG oppose LWC's proposed changes, which they say move rates farther from cost and violate the Commission policy of basing rates, to the extent possible and reasonable, on cost. CUB/AG recommend that the Commission reject LWC's proposed rate changes and retain the existing rates. (CUB/AG brief at 3)

CUB/AG argue that LWC proposes moving residential rates farther above cost, while moving industrial and other water utilities rate farther below cost. It is CUB/AG's position that the allocation made under the current rates reasonably limited the increase in the first usage block in light of the "substantial" over-recovery of costs from the residential class, compared to the large use classes. They believe the current allocation reflects a fairer cost recovery than the method recommended by LWC. (CUB/AG brief at 3-5)

CUB/AG argue that in addition to moving rates farther from cost, LWC's proposal would result in the residential customers of the Southern, Peoria and Streator districts paying more than they currently pay to compensate for the revenue shortfall resulting from the City of O'Fallon's lower, negotiated rate. CUB/AG state that the LWC's proposed increases in the rate for the first usage block shifts cost recovery for large volume users to small volume customers. In CUB/AG's view, because small volume customers already pay substantially above cost, such an increase represents an unfair shift of cost recovery from large volume users to small volume users. (CUB/AG brief at 5)

According to CUB/AG, the LWC proposal would encourage the Company to shift costs from large use customers, who may have alternatives and therefore could pressure the Company to reduce costs, to small use residential customers who individually do not have the requisite size to influence Company costs or rates. (CUB/AG brief at 6)

CUB/AG argue that the change proposed by LWC is an unnecessary and disruptive rate increase for residential customers. They say that while the residential increases are estimated to be 7 cents per month for typical monthly residential use, the size of the increase depends on usage because the rate per Ccf would be increased. CUB/AG also assert that residential customers will legitimately question why their rate is creeping up so soon after the August/September, 2003 increase. CUB/AG believe that the reductions the proponents of the rate change would see are outweighed by the confusion and unfairness that the change would cause residential users. (CUB/AG brief at 6-7)

In their reply brief, CUB/AG complain that LWC does not address that the vast majority of O'Fallon's usage was at the larger volume rate. According to CUB/AG, the larger users as a whole are paying an even smaller portion of their cost of service because of the City of O'Fallon contract, and the slight increase in their large volume rate resulting from the final order is consistent with trying to align rates with costs. (CUB/AG reply brief at 2)

### **LWC Response**

In its reply brief, LWC claims that the purpose of this rehearing is to develop an adjustment to the approved "cost-based" rates to recover a revenue shortfall produced by a discounted competitive rate for the City of O'Fallon approved in the August 12, 2003 Order. (LWC reply brief at 2-3) LWC argues that the Commission did not grant a rehearing in order to establish the appropriateness of Staff's cost of service study and the development of cost-based rates. Rather, LWC asserts, the rehearing was granted solely to address the appropriate method to reallocate the revenue shortfall produced from the discounted competitive rate offered to the City of O'Fallon. LWC claims it was the only party in this proceeding to offer a methodology for reallocating the discount to the City of O'Fallon and adjusting Staff's cost-based rates. (LWC reply brief at 2)

According to LWC, the Commission established the appropriate cost-based rates based on Staff's cost of service study, but indicated that the revenue shortfall from the City of O'Fallon should be allocated back among those cost-based rates as prescribed by Staff. LWC says that Staff, however, did not prescribe a specific allocation methodology to adjust customers' rates for the City of O'Fallon's revenue shortfall. (LWC reply brief at 3)

LWC states that Staff did express an opinion on an "appropriate shortfall" if the revenue increase prescribed by the Commission is less than 5% of that recommended by Staff. LWC argues that its proposed reallocation of the revenue shortfall is consistent with Staff's proposed adjustments to cost-based rates to reflect differentials in the revenue requirement. In LWC's view, contrary to the AG's arguments, this rehearing is not intended to establish an appropriate cost-based rate. LWC contends that cost-based rates have already been established in the August 12, 2003 Order and the AG did not appeal that decision. LWC claims the issue on rehearing is to develop an appropriate method to adjust the cost-based rates to reflect the reallocation of the revenue shortfall produced by the City of O'Fallon's competitive rate. (LWC reply brief at 3-4)

LWC also argues that the impact upon residential customers, as a class, is negligible. LWC claims the average residential customer would see only a 6.5 cent increase in his or her monthly bill under LWC's proposal. In LWC's view, CUB/AG are wrong to suggest that the proposal will have a significant impact upon residential customers. LWC asserts that CUB/AG ignore that members of LWC serve thousands of

residential customers themselves and that any cost imposed upon such members are passed through to those residential customers. (LWC reply brief at 4)

According to LWC, CUB/AG are not correct when they suggest that LWC's proposed rates unfairly shift costs. LWC claims that the Commission recognized there were certain defects in the Staff's cost study in this case and directed that they should be addressed in the next case. LWC argues that until those issues are addressed, one cannot say with any certainty that inappropriate cost shifting will occur as a result of LWC's proposed rates. (LWC reply brief at 4)

In response to IAWC's argument that Mr. Gorman's Schedule 1 contains errors, LWC says it does not object to IAWC's proposed corrections to LWC witness Gorman's rates. LWC claims that these corrections have de minimus impact on LWC's proposed rates and recommends that the Commission approve LWC's proposed rates with IAWC's corrections. (LWC reply brief at 4)

In LWC's view, IAWC's argument that there is no reason to change the compliance rates is misplaced. LWC says that the Commission specifically stated that the City of O'Fallon's competitive rate revenue shortfall should be based on the Staff's proposed methodology. (LWC reply brief at 4, citing August 12, 2003 Order at 124) LWC asserts that Staff, however, did not propose a methodology for reallocating this shortfall. According to LWC, the only revenue shortfall allocation methodology supported by Staff in this proceeding is that proposed by LWC witness Gorman. (LWC reply brief at 4)

In further response to IAWC, LWC asserts that at the time of the August 12, 2003 Order, no party proposed a methodology in the record to reallocate O'Fallon's revenue shortfall. LWC claims that its proposed rates cure a "major deficiency" in the Commission's Order. According to LWC, there was no alternative revenue shortfall allocation proposed by Staff, the Company or CUB/AG. LWC believes the Commission should adopt a methodology for reallocating the revenue shortfall that has a basis in the record and only LWC offered an allocation methodology in this proceeding. (LWC reply brief at 5)

LWC argues that IAWC provides no credible support for its contention that LWC's proposed rates would cause customer confusion and rate instability nor has IAWC provided meaningful support that it would create unnecessary additional costs. LWC contends that the Company has not provided an alternative rate methodology to support an appropriate and reasonable reallocation of the City of O'Fallon revenue shortfall. LWC also asserts that IAWC has not identified the methodology that was used in developing the current rates. LWC complains that the methodology used to develop the existing rates has not been disclosed, defined or described in any way in the record in this case; therefore, LWC asserts, the compliance rates cannot be shown to be reasonable. (LWC reply brief at 5)

It is LWC's position that IAWC's arguments that LWC's proposed rates would create further departures from cost of service are also without merit. LWC maintains that cost of service rates have already been established in this proceeding and the only adjustment to those rates is to be based on an appropriate reallocation of the City of O'Fallon's revenue shortfall. LWC avers that the only legitimate way to prevent movement away from cost-based rates would be to reject the Company's proposal to adjust cost-based rates to recover the lost revenue produced by the City of O'Fallon's competitive rate from other customers. (LWC reply brief at 5-6)

### **C. Commission Analysis and Conclusions**

The parties are at issue over how to allocate the revenue shortfall of approximately \$330,000 resulting from the discounted rate to be paid by the City of O'Fallon pursuant to its agreement with IAWC. As explained above, the Commission approved the rate after finding that O'Fallon does in fact have a competitive alternative by which sufficient supplies of wholesale water could be obtained at a price more economic than that available under the Company's regular rates, and that there is a strong possibility O'Fallon would leave the system if a competitive rate were not available from the Company.

The Commission further determined that retaining O'Fallon as a customer on the IAWC system will still provide significant net benefits to other customers, even if the revenue shortfall is allocated to them, because the amount of revenues lost if O'Fallon left the system is approximately seven times the amount of the revenue shortfall being allocated. Further, the Commission found that rates for other customers should be adjusted to cover the revenue shortfall resulting from the O'Fallon rate, using the methodology set forth by Staff. The Commission notes that rates intended to reflect the effect of allocating the shortfall from the O'Fallon discounted rate had been presented by Staff in its brief filed May 21, 2003, which preceded the filing of reply briefs, the proposed order, briefs on exception and reply briefs on exception.

It appears the rates that were filed by the Company after entry of the Order, and are currently in effect, were designed to recover the revenue shortfall in the manner reflected in the initial brief filed by Staff on May 21, 2003. LWC contends that such rates are not reasonable.

According to LWC, the methodology used to develop the existing rates has not been adequately explained; whereas, LWC's proposed rates reflect a methodology for allocating any O'Fallon revenue shortfall that is consistent with Staff's methodology for allocating the difference between Staff's proposed revenue requirement and the revenue requirement ultimately approved by the Commission. The LWC's methodology allocated the revenue shortfall to customer classes based on an equal percentage basis to the standard usage rates. LWC also claims it was the only party in this proceeding to offer a methodology for reallocating the discount to the City of O'Fallon and adjusting Staff's cost-based rates.

IAWC and CUB/AG contend, among other things, that LWC's proposed rates should not be adopted because those rates would cause further departures from cost of service. They say that under current rates, residential customers already pay in excess of cost of service and that LWC's proposal would only exacerbate this situation. The Company presented a "percentage of cost of service" chart showing revenues as a percentage of cost of service, by class, at currently filed rates and at the rates recommended by LWC. (IAWC Rehearing Ex. SR-1 at 2-3)

In Staff's opinion, the rates currently in effect and the rates proposed by LWC are both reasonable alternatives, "depending upon the Commission's priorities". Staff believes the LWC proposal is a reasonable formulaic approach, while the "the rates currently in effect also have merit because they place more of an emphasis upon minimizing the allocation of the O'Fallon discount to residential customers [who are] already paying a fairly significant percentage above cost of service."

Having reviewed the record in this proceeding and the arguments of the parties, the Commission agrees with Staff that both alternatives before the Commission have merit. In the Commission's opinion, the rates that are currently in place represent the better alternative and they should remain in effect. Hence, LWC's proposal, though well articulated in LWC's testimony and briefs, should not be adopted at this time. As explained by Staff, the current rates place more of an emphasis upon minimizing the allocation of the O'Fallon discount to residential customers, who are already paying rates designed to generate revenues several percentage points above cost of service. The LWC proposal, on the other hand, would push residential rates further above cost. Under the circumstances, to further increase rates for the residential class on rehearing would not be the more appropriate result.

The Commission has some other observations to make regarding various arguments advanced by LWC. LWC claims that it was the only party to offer a methodology for reallocating the discount to the City of O'Fallon and adjusting Staff's "cost-based rates". As noted above, in its August 12, 2002 Order, the Commission found that rates for other customers should be adjusted to cover the revenue shortfall resulting from the O'Fallon rate using the method set forth by Staff. The rates that were filed by the Company after entry of the Order, and are currently in effect, were designed to recover the revenue shortfall in the manner reflected in the initial brief filed by Staff on May 21, 2003. Furthermore, both Staff and IAWC presented evidence on rehearing explaining why, in their opinions, such rates are a reasonable approach for effectuating the revenue allocation in question. Hence, the record contains evidence on both alternatives before the Commission for consideration.

The Commission will also comment on LWC's numerous references to the approval of "cost-based rates" in the Commission's Order of August 12, 2003, as support for LWC's proposal on rehearing. It is not totally clear what LWC means when it says the "Commission established cost-based rates". However, if LWC is implying that the August 12, 2003 Order set rates for each customer class at cost of service before adjusting for the O'Fallon revenue shortfall, such a suggestion is simply

incorrect. While percentage increases for the industrial class were, for most districts, somewhat higher than the percentage increases for the residential class, thereby making progress toward setting rates at cost, the class revenues collected from the residential class are still above calculated cost of service as the parties are well aware. Thus, LWC's reliance on the argument that "the Commission established cost-based rates", as support for LWC's position on rehearing, is unavailing. As noted above, under LWC's proposal, residential customers would pay even more in excess of cost of service.

In support of its recommendation, LWC also argues that its proposal is consistent with the Commission's adoption of Staff's proposed methodology for allocating any difference between Staff's proposed revenue requirement and the revenue requirement ultimately approved by the Commission. The Commission observes, however, that the "revenue requirement", also shown as approved Operating Revenues in Appendix A to the Order of August 12, 2003, is not at issue here. That is, at least in this case, the Company's calculated revenue requirement is not affected by the O'Fallon agreement. Instead, at issue is the manner in which a revenue shortfall from O'Fallon should be imposed on the other customers. The approved revenue requirement remains the same, regardless of how the revenue shortfall from the O'Fallon agreement is allocated. Given the circumstances present here, as discussed above, the Commission does not believe LWC's proposal should be adopted for purposes of allocating the O'Fallon revenue shortfall.

The Commission also has brief observations to offer regarding certain arguments made by IAWC. The Company says LWC's proposal should be rejected because a change in rates after only six months creates rate instability. The problem with such a proposition is that it could arguably prevent the Commission from ever modifying rates on rehearing, which would be an inappropriate policy. Also, the complaint by the Company that the LWC proposal would cause the Company to incur additional costs to implement it is not persuasive. The Company did not present the agreement with O'Fallon until the day of the hearings in the original case. Hence, the opportunity of other parties to address all elements of this issue were somewhat limited. Under those circumstances, it would be unfair to other parties to deny their proposals offered on rehearing simply because the Company would allegedly incur additional costs to implement them. In any event, the Commission has not based its conclusions in this Order on either of these arguments made by IAWC.

In summary, the Commission finds that the current rates allocate the revenue shortfall from the O'Fallon agreement an appropriate manner, and they should remain in effect.

**V. FINDINGS AND ORDERING PARAGRAPHS**

The Commission, having reviewed the entire record herein, is of the opinion and finds that:

- (1) Illinois-American Water Company is a corporation engaged in the business of furnishing water service and sewer service to the public in various areas in the State of Illinois, and is a public utility as defined in the Public Utilities Act;
- (2) the Commission has jurisdiction of the parties and of the subject matter herein;
- (3) the findings made and conclusions reached in the prefatory portion of this Order are supported by the evidence of record and are hereby adopted as findings of fact;
- (4) except as otherwise specifically ordered herein, the findings and conclusions contained in the Order entered August 12, 2003 should be affirmed;
- (5) the tariff sheets filed pursuant to the Order of August 12, 2003 should remain in effect.

IT IS THEREFORE ORDERED that that on or before September 30, 2004, IAWC shall make the filing described under "Management Fees" in Section V of the Order of August 12, 2003 and in Section III of the instant order above.

IT IS FURTHER ORDERED that the tariff sheets filed pursuant to the Order of August 12, 2003 shall remain in effect.

IT IS FURTHER ORDERED that except as otherwise specifically ordered herein, the findings and conclusions contained in the Order entered August 12, 2003 are hereby affirmed.

IT IS FURTHER ORDERED that all objections or motions that have not been ruled upon are hereby deemed disposed of in a manner consistent with the ultimate conclusions contained herein.



IT IS FURTHER ORDERED that subject to the provisions of Section 10-113 of the Public Utilities Act and 83 Ill. Adm. Code Section 200.880, this Order is final; it is not subject to the Administrative Review Law.

By proposed order this 12th day of January, 2004.

Administrative Law Judge